DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0175
Individual Income Tax
For the Tax Year 1998 and 1999

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ISSUES

I. "S" Corporation's Vehicle / Advertising Expense Deduction.

Authority: 45 IAC 3.1-1-66; I.R.C. § 179.

Taxpayer argues that the audit erred in disallowing the purchase price of a vehicle as a business expense.

II. Disallowance of "S" Corporation Business Gift.

Authority: I.R.C. § 162(a); I.R.C. § 274(b)(1); I.R.C. § 2503(b).

Taxpayer maintains that the audit improperly disallowed, as a business expense, the value of a computer which had been given to a family member as a gift.

III. Home Office Expenses for "S" Corporation.

Authority: I.R.C. § 162(a); I.R.C. § 280A.

Taxpayer argues that the S-Corporation is entitled to claim home office expenses as a business deduction.

STATEMENT OF FACTS

There are two independent players involved in this protest; the individual taxpayer and the taxpayer's business (*Hereinafter* "S-Corporation"). The business is qualified to file as an "S" corporation and did so for a number of years. However, in 1998 and 1999, the taxpayer filed incomplete tax returns for the S-Corporation. For 1998, taxpayer – on behalf of the S-Corporation – submitted the appropriate federal S corporation (1120S) return but did not submit

or prepare the state S corporation return (IT-20S). In 1999, taxpayer prepared neither the state or federal S corporation returns. However, on taxpayer's own individual 1040 return, taxpayer attached a "Schedule C" (Profit or Loss From Business – Sole Partnership). On that Schedule C attachment, taxpayer claimed certain business expenses attributed to the S-Corporation.

Both the taxpayer and the S-Corporation were audited. Because the taxpayer failed to file Indiana S corporation returns for 1998 and 1999, those particular returns were completed on behalf of the S-Corporation. The audit prepared two S corporation returns based upon the existing 1998 S corporation federal return and the information contained within the taxpayer's individual 1999 Schedule C. The audit made certain adjustments and disallowed certain business expenses claimed on the 1999 Schedule C. It is those particular adjustments which form the basis for the protest which follows.

No tax was assessed against the S-Corporation. However, the disallowance of the S-Corporation's 1999 expenses resulted in additional income which flowed through to the taxpayer as – apparently – the sole shareholder of the S-Corporation. Therefore, although the protest stems from the assessment of *individual* income taxes, because of the relationship between taxpayer and the S-Corporation, the resolution of the issues raised by that assessment requires consideration of both S corporation and individual income tax questions.

Taxpayer – acting for both himself and the S-Corporation – challenged the assessment of the additional 1999 individual income taxes, an administrative hearing was held, and this Letter of Findings follows.

DISCUSSION

I. "S" Corporation's Vehicle / Advertising Expense Deduction.

An S corporation normally does not pay income tax. 45 IAC 3.1-1-66, states that, "Corporations electing Subchapter S status under Internal Revenue Code § 1372 . . . are exempt from adjusted gross and supplemental net income tax on all income except capital gains . . . ." Rather than taxing the income at the business level, the S corporation's income is passed through to the shareholders. The shareholders then must report the income on their own income tax return. 45 IAC 3.1-1-66 states that, "Subchapter S corporation shareholders are taxed on their distributive shares of income at the individual income tax rate." This is the dilemma in which taxpayer finds himself; because certain of the S-Corporation's deductions were disallowed, additional taxable income flowed through to the taxpayer as the S-Corporation's shareholder. It was this additional flow-through income which led to the imposition of additional, individual income taxes.

The S-Corporation purchased a vehicle in 1999 for approximately $5,800. Taxpayer – on behalf of the S-Corporation – argues that the S-Corporation was entitled to deduct immediately the total purchase price of the vehicle under I.R.C. § 179. Taxpayer – again on behalf of the S-Corporation – maintains that the vehicle is not a "vehicle" for purposes of state or federal income tax. According to taxpayer, the vehicle is "used as advertising in front of the [S-Corporation's] retail store. Therefore, the taxpayer maintains that the purchase of the "vehicle" was more akin to the acquisition of a stationary, permanent, advertising display.

The audit disagreed with the taxpayer's argument. Instead of treating the purchase of the vehicle as an ordinary business expense under I.R.C. § 179, the audit – under I.R.C. § 280F – "depreciated" the entire vehicle cost over a five-year period because the vehicle was used exclusively for business purposes. That is, rather than allowing the entire $5,800 as a wholesale business expense deduction, the audit allowed the S-Corporation to claim a $1,160 deduction on the S-Corporation's 1999 tax return. Presumably, the same "straight line" deduction will be available to the S-Corporation in 2000, 2001, 2002, and 2003.

Taxpayer states that the vehicle is permanently parked in front of the S-Corporation's retail site and that such an arrangement is necessary in order to attract attention to the site's location. In addition, taxpayer indicates that– at least temporarily – the vehicle is immobile because the battery has been removed. However, it should also be noted that the audit report indicated that the vehicle had certain "mileage" during the tax period.

This does not seem to be an instance in which a vehicle has been purchased, reconditioned, immobilized, and permanently adopted as a fixed advertising structure. However necessary it may be that the vehicle remain parked in front of the S-Corporation's business location, the vehicle remains a "vehicle." The audit did not err in requiring that the original purchase price be depreciated over the five-year period.

FINDING

Taxpayer's protest is respectfully denied.

II. Disallowance of "S" Corporation Business Gift.

The S-Corporation gave a disused computer to taxpayer's daughter. The computer was assigned a value of $650 and was claimed by the S-Corporation as a business expense in 1999. The gift may have been a sensible way in which to dispose of a computer which had become obsolete for purposes of the S-Corporation; however, taxpayer fails to explain in what manner the S-Corporation is entitled to claim the gift as a "business expense." Taxpayer claims that the S-Corporation is entitled to give up to $10,000 in gifts. Insofar as it relates to the S-Corporation's state income tax liability, taxpayer is mistaken. Under I.R.C. § 274(b)(1), the S-Corporation is limited to claiming a deduction for business gifts, made either directly or indirectly, up to $25 per recipient each year.

Taxpayer's assertion – that the S-Corporation is entitled to make an annual gift of up to $10,000 per year – may be a reference to the gift tax exclusion which the donor of a gift is entitled to claim under I.R.C. § 2503(b). Under that provision, the first $10,000 of gifts made by a donor to any recipient is not included in the total amount of the donor's taxable gifts during that year. However taxpayer – or more accurately, the S-Corporation – is seeking relief from an assessment of additional income taxes. Whether or not the S-Corporation is entitled to the $10,000 gift tax exclusion is irrelevant; the issue is whether or not the S-Corporation may claim the $650 as a "business expense." On this question, taxpayer's protest fails because there is no indication that the cost of giving away a computer is an "ordinary and necessary business expense . . . ." I.R.C.

§ 162(a). Taxpayer's relief is limited to the extent that the S-Corporation is entitled to claim the $25 business gift deduction provided under I.R.C. § 274(b)(1).

FINDING

Taxpayer's protest is respectfully denied.

III. Home Office Expenses for "S" Corporation.

Taxpayer – on behalf of the S-Corporation – argues that the S-Corporation was entitled to claim a deduction for business expenses based upon the taxpayer's own individual home office deduction. Simply stated, taxpayer – as an individual and shareholder – performed the necessary calculations and determined that he was entitled to claim an approximately $3,000 "home office" deduction on his individual 1999 federal income tax return. Consequently, according to taxpayer, the S-Corporation is entitled to claim an identical amount as one of S-Corporation's ordinary business expenses.

Taxpayer is correct in his assertion that he may be individually entitled to claim a deduction for home office expenses under I.R.C. § 280A. The Department does not challenge the taxpayer's claim to a home office deduction on his individual income tax return for 1999.

The S-Corporation – as a separate entity – is entitled to claim under I.R.C. § 162(a) a deduction for "all the ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business." However, the S-Corporation and the taxpayer cannot have it both ways. If, under I.R.C. § 280A, taxpayer individually incurred expenses attributable to operating the business from his home, then taxpayer was entitled to deduct the general "home office" deduction on his individual federal income tax returns. If the S-Corporation incurs particularized "ordinary and necessary business expenses," then the S-Corporation was entitled to claim those *particular* expenses as a deduction under I.R.C. § 162(a). It is immaterial whether the S-Corporations business expenses are attributable to its retail location or to the business activities conducted at the taxpayer's own home. However, taxpayer mistakenly regards his own expenses and the expenses of the S-Corporation as two sides of the same coin. The taxpayer may be entitled to claim home office expenses on his individual tax return. The S-Corporation may be able to demonstrate that it incurred its own "ordinary and necessary expenses." Nevertheless, an individual employee's home office expenses and a corporation's "ordinary and necessary expenses" are not the same; the two sets of expenses are incurred by two distinct entities, the two are computed differently, and they are attributable to entirely different taxpayers.

Taxpayer makes much of the fact that the nature of the S-Corporation requires it to have two federal licenses. However, whether the S-Corporation has two or twenty licenses is unconnected with the question of whether the S-Corporation did not or did not incur "ordinary and necessary expenses." In this instance, taxpayer may be legitimately entitled to claim the home office deduction on his personal federal income tax return. However, the S-Corporation – as a separate taxable entity – must search elsewhere in order to locate and specifically identify its own "ordinary and business expenses."

Taxpayer is entitled to organize his business as an S corporation under federal and state law and to obtain the distinct advantages attributable to such an arrangement. However, having done so, taxpayer is required to distinguish between those expenses he incurred and those expenses the S-Corporation incurred.

FINDING

Taxpayer's protest is respectfully denied.

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